

## Investment Strategy Bulletin

## May's saga weighs on sterling

Investment Solutions

23 May 2019

### Key takeaways

- Theresa May offered a repackaged version of her withdrawal agreement that utterly failed to support sterling.
- GBP downside risks have increased. After an initial rally on the headlines about a second referendum, GBPUSD reversed course and is now trading at its lowest level since early January.
- UK news outlets suggest that Ms May is close to resigning; if so, this would pave the way for, potentially, Boris Johnson to become the next PM.
- The hard-Brexit risk premia could increase and further weigh on sterling.
- Investors willing to hedge their GBP portfolio exposure can consider implementing GBPJPY option strategies.

### Fourth time not a charm

On 21 May, in a likely last roll of the dice, British Prime Minister Theresa May unveiled a new version of her withdrawal agreement (WA). The key point of this updated version was that MPs would be given the chance to vote for the possibility of a second Brexit referendum, conditional however on her WA being ratified by the parliament in early June. Ms May admitted that if her proposal did not go through, there would have to be a general election or a second referendum. Her attempt, however, has only succeeded in making a bad situation worse: it has aggravated hard Brexiteers and failed to harness any support from the Labour Party, with Labour leader Jeremy Corbyn dismissing it as a “repackaging” of the old deal. Then, on 22 May, Andrea Leadsom, leader of the House of Commons and strong supporter of the Leave campaign, resigned in a clear lack of willingness to support Theresa May's deal. This suggests that the chances of the withdrawal agreement being ratified are very slim, let alone the possibility that the modified agreement may never make it to the parliament in the first place.

**The downside risks to GBP we discussed in the May edition of our [FX Monthly](#) are materialising at a very rapid pace and have now become our central near-term scenario.** Not only is this bad for general confidence in the political system and unequivocally negative for the pound, it is a major blow to PM May, who several UK newspapers have suggested may resign soon. If she does, the UK political risk premia would increase due to a troubled political backdrop. The ratcheting-up of political tensions could also persuade more hard-liners to go to the EU polls, suggesting a further boost to Nigel Farage's Brexit Party.

Historically, the British voters have not been very eager to participate in these elections, with a turnout of just 35.6% in 2014 and 34.7% in 2009. Nigel Farage's Ukip party topped the 2014 European elections with 26.6% of the vote. It is therefore not surprising to see Mr Farage leading the opinion polls this time again. However, the main difference is that there has been a marked increase in his new party's estimated share of votes, which is close to 35%, while Labour and Conservatives

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are expected to decline steeply, according to opinion polls. Naturally, if hard-liners increase their turnout, the Brexit party could win more votes. This in turn would increase the odds of Boris Johnson being named the new PM as he is likely to be seen the most capable to stop the drainage of voters towards Nigel Farage's party.

Hard Brexiteer Boris Johnson could be named Prime Minister sometime between late August and early September. **Such a development would be negative for sterling**, largely because of Johnson's hard stance on the EU. It is difficult to speculate about what could happen after that, because even if Johnson attempts to reopen the issue of the Northern Ireland "backstop", the EU's response will most likely be a firm "no". If the hard Brexit scenario starts gaining traction in markets, GBP could return to levels last seen in October 2016.

There is then the possibility that the UK may end up with general elections, which is something that Labour would welcome. While Prime Minister May has managed to put the Conservative Party in disarray, Boris Johnson is not particularly popular among certain conservative circles. There is no easy way to assess the evolution of things given the high level of political uncertainty. What seems increasingly probable, however, is that a strong performance by Farage in the EU

elections and May's replacement by a hard Brexiteer would make things worse for sterling before they could get better.

### **Portfolio implications**

Our central scenario remains a soft Brexit. Nevertheless, 1. This will be a lengthy process that could potentially extend beyond 30 October (via another extension) and 2. The probability of a hard Brexit scenario seems to be increasing, at the margin.

In our GBP portfolios we turned underweight GBPJPY in mid-May (relative to our benchmark), because we feel this currency pair will best capture the combination of risks emanating from higher UK political risk premia and US-China trade tensions. However, we are cognizant of the fact that as of now, almost all sterling crosses have stepped into oversold territory. In the light of this development and since implied volatility is still relatively low by historical standards, it would make sense for investors who haven't participated in GBP downside to implement low-cost option structures (such as GBPJPY put spreads) with a one-month horizon, by which time there could be more clarity on the UK's political leadership.

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